

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

75-7231

IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

No. 75-7231

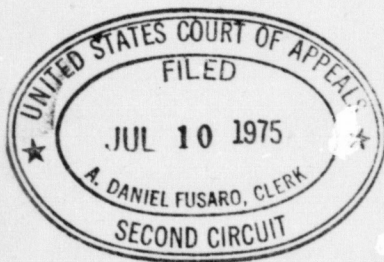
EINAR A. HELDING,
Plaintiff-Appellee

vs.

STAMFORD MOTORS, INC.,
Defendant-Appellant

On Appeal From The United States District Court
For The Southern District Of New York

**BRIEF OF DEFENDANT-APPELLANT,
STAMFORD MOTORS, INC.**



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STATEMENT OF ISSUES ON APPEAL

Did the court err in entering summary judgment for plaintiff in a suit concerning an agreement for the redemption by defendant of plaintiff's 25% stock interest in defendant, where plaintiff claimed a right to an adjustment in the \$505,000 purchase price based on a provision for such adjustment in the event that certain real property owned by the defendant was sold within three years at a "net selling price" (after taxes and other charges) greater or less than \$700,000 and (A) there was a dispute as to the amount of legal fees to be deducted from "selling price" to determine "net selling price" and the judgment reflected plaintiff's disputed contention in relation thereto, (B) said property was not "sold" but merely exchanged for another piece of property in Stamford with no receipt of cash by defendant, and (C) the court's decision as to the "net selling price" made no provision for deferred taxes incurred as required by the agreement and generally accepted accounting principles and was based on an unjustified assumption that there was a "selling price".

STATEMENT OF THE CASE

This case involves a claim by the plaintiff for monies allegedly due him pursuant to a provision of a stock purchase agreement between the plaintiff and the defendant and an alternative counterclaim by defendant for monies allegedly due it under the same provision, if it was determined that the exchange transaction constituted a "sale" for purposes of the agreement.

On January 10, 1975, the Court, Hon. Lee P. Gagliardi, United States District Judge, rendered an opinion granting the plaintiff's motion for summary judgment and denying the defendant's cross-motion for summary judgment.

The defendant then moved for reargument emphasizing that it did not agree that there was a "sale" within the meaning of the agreement. The Court granted the motion for reargument but adhered to its previous decision by memorandum endorsement dated March 4, 1975.

The Court entered judgment in favor of plaintiff on March 24, 1975 and the defendant appealed from such judgment by notice of appeal dated April 8, 1975.

With respect to the motion for summary judgment, the plaintiff submitted no affidavit other than the affidavit of his attorney, David Fleischer. (9A et. seq.)* The defendant submitted an affidavit sworn to by David A. Broudy, the defendant's accountant (119A), and another affidavit sworn to by George G. Vest, Secretary of the defendant (95A et. seq.).

The following claims of fact were made in these affidavits.

*References to "A" are to the Joint Appendix.

On December 19, 1969 defendant and plaintiff entered into a stock purchase agreement (the "Agreement" [15A]). (Vest Affidavit, paragraph 3 [119A]). Pursuant to the Agreement, the plaintiff agreed to sell his 25% interest in the defendant to the defendant for \$255,000 in cash and three promissory notes of defendant each in the amount of \$83,333.33. The purchase price represented the proportionate value of the net worth of Stamford Motors, Inc., determined by book value adjusted in certain respects so as to reflect the fact that certain assets had appreciated. (Vest Affidavit, paragraph 3 [95A]; certified financial statements of Stamford Motors, Inc., Auto Lease of America, Inc., and Kelsing Realty, Inc. attached as Exhibits 1, 2 and 3 to the Vest Affidavit [100A et. seq.]).

Stamford's principal asset that had appreciated in value was real property located on South Street (now Washington Blvd.) in Stamford, Connecticut ("the South Street Property") (Vest Affidavit, paragraph 4 [96A]). The value of said property on the books of Stamford as of June 30, 1969 was approximately \$137,000, representing the tax basis of said property after depreciation (Schedule A to Exhibit 1, supra [103A]). The parties agreed, however, that the net value of the property for purposes of fixing the redemption price was \$700,000, (Agreement Paragraph 3, Vest Affidavit paragraph 4 [15A, 96A]) subject to the adjustment provisions of Paragraph 3 which came into effect in the event of a sale of the South Street Property within three years. (Vest Affidavit, paragraph 5 [96A]).

Paragraph 3 of the Agreement provides as follows:

"3. Subsequent Events, Increase or Reduction of Redemption Price: Stockholder and Company further agree that in the event the real estate presently owned by the Company and located on South

Street in Stamford, Connecticut, is sold within three years from the date of this agreement and the net selling price (as hereinafter defined) is greater than or less than \$700,000 then (a) in the event it is greater than \$700,000, Company shall pay Stockholder as an increase in the redemption price 25% of the difference between the net selling price and \$700,000; or (b) in the event it is less than \$700,000, Stockholder shall pay Company as a decrease in the redemption price 25% of the difference between the net selling price and \$700,000. For purposes of this paragraph 'net selling price' shall mean the selling price of the real estate computed by deducting all expenses incurred by the Company attributable to the sale including, but not limited to, commissions, legal fees, transfer taxes and all Federal, state or local income or other taxes payable by the Company, if any. Amounts payable under this paragraph shall be paid 90 days after the date the real estate is sold. In the event payments are due Company from Stockholder, Company may reduce the principal payment of the notes issued under paragraph 2 to obtain payment under this paragraph." (16A-17A).

This paragraph was designed to permit the parties to proportionately increase or decrease the redemption price in the event the South Street Property was sold within three years for a net amount which was greater or less than \$700,000. The Agreement provided that "net selling price" shall mean the selling price of the South Street Property computed by deducting all expenses incurred by defendant attributable to the sale. No expenses were excepted whether they were prepaid, accrued or deferred expenses, since the intention of the parties was to increase or decrease the redemption price by 25% of the amount that the net worth of Stamford (as adjusted by including the South Street Property at

\$700,000) was increased or decreased by reason of the disposition of the South Street Property (Vest Affidavit, paragraph 6 [16A-18A]).

On or about August 16, 1972 Stamford exchanged the South Street Property and \$212,138.00 cash for real property located at Magee Avenue, Stamford, Connecticut (Broudy Affidavit, paragraph 4 [119A-120A]). For purposes of the exchange, the parties to the exchange arbitrarily assigned the sum of \$830,000 to the South Street Property (Broudy Affidavit, paragraph 5 [120A]; Complaint, Exhibit B [19A]). However, there is no proof in this record that this figure represents the fair market value of either the South Street Property or the property received in exchange therefor. In fact, by the plain language of the exchange agreement, defendant had no right to receive \$830,000 in cash but only a right to receive the Magee Avenue Property.

Defendant, a closely held corporation, keeps its books of account, including its assets and liabilities and income and expenses, as such items were reflected on its federal income tax returns, and not in accordance with generally accepted accounting practice. (Broudy Affidavit, paragraphs 6 and 7 [120A-121A]). Since the exchange of the South Street Property for the Magee Avenue Property qualified as an exchange of like kind property within the meaning of Section 1031 of the Internal Revenue Code, with the consequence that no gain or loss was recognized to defendant for Federal Income Tax purposes, defendant's books of account reflected no income by reason of the exchange. Instead, Stamford's basis for the Magee Avenue Property on its books of account is the same as its basis for the South Street Property, increased by the additional \$212,138.00 cash consideration paid by defendant for the Magee Avenue Property (Broudy Affidavit, paragraph 6 [120A]). Since no income was recognized on

the exchange, Stamford's assets, liabilities and net worth for Federal Income Tax purposes remained the same and were not increased or decreased by reason of the exchange of like kind property. (Broudy Affidavit, paragraph 6 [120A]).

In view of the fact that no cash or credit was received by defendant with respect to the transfer of the South Street Property, but rather that there was a like kind exchange which was not a sale within the meaning of the tax laws, defendant claims the transaction in question was not a "sale" for purposes of the Agreement but rather an exchange of property not subject to Paragraph 3 of the Agreement. In determining the selling price of plaintiff's stock the parties had used defendant's book value per its tax returns adjusted to reflect the appreciation in value of certain of its assets. (Vest Affidavit, paragraph 3, Broudy Affidavit, paragraph 6 [95A, 96A, 120A]). At that time the precise value of the South Street Property was unknown and the parties fixed a net price of \$700,000 with a provision that in the event the precise value of the property should be determined by sale within three years an appropriate adjustment would be made. (Vest Affidavit, paragraph 5, [96A]). In fact, the precise cash value of the South Street Property has never been determined.

On the other hand, if we assume a sale, generally accepted accounting principles would require that defendant reflect as pretax accounting income the amount of the value of the property received less the book value. (Broudy Affidavit, paragraph 7 [121A]). Such principles would further require defendant to record the property received on its balance sheet at its fair market value, offset, however, by a deferred liability in the amount of the tax that would have been paid by defendant if it had in fact sold the South Street Property for cash. (Id.) Under this approach, assuming the South Street Property to

have been exchanged for property worth \$830,000, the amount of the deferred tax incurred is \$2⁰⁰,239.00, which represents Federal Capital Gains Tax computed at a 30% rate in the amount of \$211,112 and Connecticut Corporation Business Tax computed at an 8% rate (after federal tax deduction) of \$52,127.00. (Broudy Affidavit, paragraph 7, Vest Affidavit, paragraph 11 [121A, 98A-99A]). Recognition of this deferred tax liability is in accordance with the method of accounting prescribed pursuant to paragraph 34 of Accounting Principles Board Opinion Number 11. (Broudy Affidavit, paragraph 7 [121A]). Such an adjustment is necessary in order to properly reflect the net worth of defendant. If the Magee Avenue Property is to be written up to \$830,000 the deferred liabilities should be reflected to properly state "net worth".

Plaintiff concedes that in connection with the transfer of the South Street Property \$913.00 was paid for transfer taxes and that this is a proper deduction in determining "net selling price". (Fleischer Affidavit, page 4 [12A]).

However, there is a dispute as to the extent to which legal fees of Cummings & Lockwood paid by the defendant are properly attributable to the transaction in question and hence deductible in determining "net selling price". Judge Gagliardi recognized this dispute in footnote 1 of his January 10, 1975 decision, and stated that:

"If the parties are unable to agree upon the appropriate amount of legal fees attributable to the sale, the matter will be referred to a Magistrate for hearing and report." (128A)

Despite this statement, judgment was nevertheless entered in favor of the plaintiff. The amount of the judgment was calculated using plaintiff's own claim that legal

fees to be deducted in determining "net selling price" should not be more than \$3,573.00 (Fleischer Affidavit, page 3 [11A]), and ignoring defendant's claim (Vest Affidavit, paragraph 11 [98A]) to the contrary.

If the transaction is to be treated as a sale and assuming a \$830,000.00 selling price less the \$263,239.00 in deferred taxes incurred, the \$913.00 paid for transfer taxes and the \$5,000.00 claimed by defendant as having been paid for attorneys fees, the amount of the "net selling" price would be \$560,848.00 which would entitle the defendant to a payment to it under Paragraph 3 of the Agreement in the amount of \$34,788, representing 25% of the difference between \$700,000 and \$560,848. (Vest Affidavit, paragraph 11[99A]). Even if we assume attorneys fees of \$3,573 as claimed by the plaintiff, the payment required by plaintiff to the defendant is still \$34,431.

Notwithstanding the foregoing, the court below entered summary judgment for plaintiff based on the assumption that the exchange of the South Street Property was a "sale", and based on the assumed \$830,000.00 selling price, no deduction for deferred taxes and the plaintiff's claim as to the amount of legal fees. (123A et. seq.; 138A).

ARGUMENT

THE COURT ERRED IN GRANTING SUMMARY JUDGMENT FOR THE PLAINTIFF ON THE MERITS.

- A. The Court Erroneously Resolved the Issue of Attorneys Fees Against the Defendant Despite the Existence of Contradictory Assertion by the Parties.

The Affidavits filed by the defendant state that the legal fees attributable to the South Street Property transaction were \$5,000.00. The plaintiff claims that the amount was less. The Court, in footnote 1 of its January 10, 1975 opinion stated that unless the parties are able to agree, "the matter will be referred to a Magistrate for a hearing and report". Notwithstanding this statement in the opinion and the fact that the parties did not agree and no such hearing was ever held, judgment was entered based on the plaintiff's claim that legal fees were \$3,573.00.

This is a manifest error.

B. The Court Below Erred In Determining That There Was A "Sale" Within The Meaning Of The Agreement.

More fundamentally, the court below erred in finding that there was a "sale" within the meaning of the Agreement. The exchange of property was not a sale for one simple reason: it did not **conclusively** fix the value of the South Street Property in terms of cash as was contemplated by the adjustment provisions of the Agreement. The redemption price for plaintiff's stock, which was based on defendant's adjusted book value, assumed a net value for the South Street Property of \$700,000. Only in the event this assumed value was **disproved** by a subsequent sale of the South Street Property was the \$700,000 value to be adjusted. The exchange of the South Street Property for the Magee Avenue Property did not **disprove** this \$700,000 figure as contemplated by the Agreement. This was not a cash sale. It was exchange of unique real property for other unique real property. To this day no one knows the actual cash value of either the South Street Property or the Magee Avenue Property, since they have not been sold for cash. A sale is more precisely defined as a transfer of property for cash or credit and not an exchange for one unique piece of property for an-

other. See **Random House Dictionary** (Random House, 1969) [defining "sale" as a transfer of property for money or credit] and **Webster's New Collegiate Dictionary** (Merriam Company, 1974) [defining "sale" as the transfer of ownership of and title to property from one person to another **for a price**. (emphasis added)].

Nor does it do the plaintiff any good to argue that the \$830,000 figure represents the fair market value of the South Street Property. The purchasers of the South Street Property were not required to pay \$830,000 to defendant for the South Street Property. They were merely required to transfer the Magee Avenue Property. The parties to the exchange agreement could have attributed any figure to the South Street Property — even one dollar — and it would not have affected their legal rights and liabilities at all. They were still obligated to exchange the unique properties. Certainly if the parties had used one dollar the plaintiff would not be arguing that the "selling price" should be reduced by one-fourth of \$699,999 or \$174,999. In these circumstances, he would not have attempted to treat the exchange as a sale.

The selling price of \$830,000 is imaginary. The defendant may or may not realize this sum on the disposition of the Magee Avenue Property. Since there was no established selling price and no cash received but only a like kind exchange, the plaintiff should not be permitted to take advantage of Paragraph 3 of the Agreement.

A determination that there was "no sale" would certainly be far more equitable than the one reached by the District Court since it would deprive the plaintiff of the windfall profit he is seeking to achieve at the expense of the other stockholders of defendant. He is not entitled to a pre-tax adjustment when he bargained for an after-tax adjustment. If there was no sale, there would be no need

to make any adjustments.

- C. The Court Awarded the Plaintiff a Windfall Profit Not Contemplated by the Agreement When It Determined There Was A Sale and Excluded From the "Net Selling Price" Determination the Amount of Deferred Taxes Incurred by Defendant for Accounting Purposes.

The intent of the Agreement was to redeem the 25% interest of the plaintiff in the defendant for a sum equal to 25% of the book value, with an adjustment for certain assets, principally the South Street Property, which had appreciated in value. The parties selected the sum of \$700,000 for this purpose for the South Street Property.

In accordance with this general intent, the provisions of Paragraph 3 of the Agreement were designed to increase or decrease the redemption price by the amount by which the net worth of defendant (as adjusted by including the South Street Property at \$700,000) was increased or decreased by reason of the property's sale within three years (Vest Affidavit, paragraph 6).

The Agreement speaks of a "sale" which normally assumes a transfer of title for cash or credit. (See Point B, *infra*). However, even assuming that somehow this exchange of property was a "sale" rather than an exchange, it is difficult to see how the court below could, at least on a summary judgment motion, reach the conclusion that it did.

The \$830,000 figure mentioned in the Agreement for exchange of property did not necessarily reflect the value of either the South Street Property or that portion of the Magee Avenue Property received in exchange therefor.

While it is true that defendant had no current liability for taxes other than transfer taxes as a result of this exchange, it is nevertheless true as the accounting profession has recognized, that if a gain is to be accounted for with respect to an exchange of property where the tax is being deferred, there must necessarily be deemed as incurred at the same time a deferred income tax liability. Since the property is held "subject to" tax it is clear that such tax liability has been "incurred" from an accounting standpoint although not currently due to the IRS. (See District Court definition of "incur" as to "become liable or **subject to**". [Emphasis added].)

If the purchase price with respect to any sale did not exceed the basis, there would be no taxes, either current or deferred. Similarly, if there were a liquidation of the defendant pursuant to §337 of the Internal Revenue Code or a distribution of property to shareholders as an ordinary dividend pursuant to §311 of the Internal Revenue Code there would be no taxes. This is why the words "if any" appear after the reference to taxes in Paragraph 3 of the Agreement. Here the taxes were merely deferred, and, as stated above, generally accepted accounting principles, which are in accord with common sense, require that all parties concerned recognize that the Magee Avenue Property is owned subject to deferred capital gains taxes which will be payable upon any sale of the Magee Avenue Property and which are computed by reference to the current adjusted basis thereof for tax purposes. Any adjustment of the sale price of plaintiff's interest in defendant should be made with this in mind.

What plaintiff wanted and got when he arranged to sell his stock to the corporation was cash. Defendant however did not get cash for its South Street Property. It got another piece of property with an unknown value which property is held subject to deferred taxes.

Current recognition of such deferred tax liability is in accordance with Accounting Principles Board Opinion No. 11 which, in relevant respects, provides as follows:

"34. The Board has considered the various concepts of accounting for income taxes and has concluded the comprehensive interperiod tax allocation is an integral part of the determination of income tax expense. Therefore, income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income. The tax effects of those transactions which enter into the determination of pretax accounting income either earlier or later than they become determinants of taxable income should be recognized in the periods in which the differences between pretax accounting income and taxable income arise and in the periods in which the differences reverse. Since permanent differences do not affect other periods, interperiod tax allocation is not appropriate to account for such differences."

"35. The Board has concluded that the deferred method of tax allocation should be followed since it provides the most useful and practical approach to interperiod tax allocation and the presentation of income taxes in financial statements."

By not taking into account this deferred tax liability the result of the decision below is that the plaintiff will receive more than the fair cash equivalent of his 25% interest in the defendant since the remaining 75% of the assets will be subject to the deferred tax liability and the plaintiff will receive after tax cash dollars.

Thus, deferred taxes should be subtracted from any selling price even though there is no present requirement that the taxes be paid to the taxing authority.

It would appear that the District Court arrived at its

decision by refusing to consider the circumstances and background of the Agreement. This refusal possibly resulted from a misconstruction of Connecticut law. Notwithstanding any statement by the District Court to the contrary, it is clear that under Connecticut law, parol evidence:

"may properly be received to show the meaning of the word or words, as understood by the parties at the time the contract was entered into, and the meaning which may properly be given to them when used in connection with the particular circumstances. **Murphy v. Schwaner**, 84 Conn. 420, 426, 80 A.295 . . . testimony was offered and received by the court for the purpose of showing the meaning of the term as used in the contract and was admissible for that purpose. This understanding of the parties was properly considered by the trial court, not for the purpose of ascertaining any unexpressed intent, but to determine the intent [the parties] meant to express by the words they used. **Maltby, Inc. v. Associated Realty Co.**, 114 Conn. 283, 289, 158 A. 548; **Gray v. Greenblatt**, 113 Conn. 535, 539, 155 A. 707; **Mirando v. Mirando**, 104 Conn. 318, 322, 132 A. 910; **In re Curtis — Castle Arbitration**, 64 Conn. 501, 515, 30 A. 769". **Fairfield Lease Corp. v. Eastern Sportswear Co.**, 6 Conn. Cir. 347, 273 A.2d 300, 302 (1970).

Thus, at least on a summary judgment motion, the court was not justified in simply ignoring the statements of the defendant indicating the intent of the parties in establishing the \$700,000 adjustment figure. This was clearly a proper aid in the interpretation of this contract. In fact, a proper understanding of the Agreement shows that to award plaintiff an affirmative recovery in this matter yields him a windfall profit at the expense of the remaining stockholders of the defendant which was not

and could not reasonably be construed to be the intent of the words used by the parties in their Agreement.

CONCLUSION

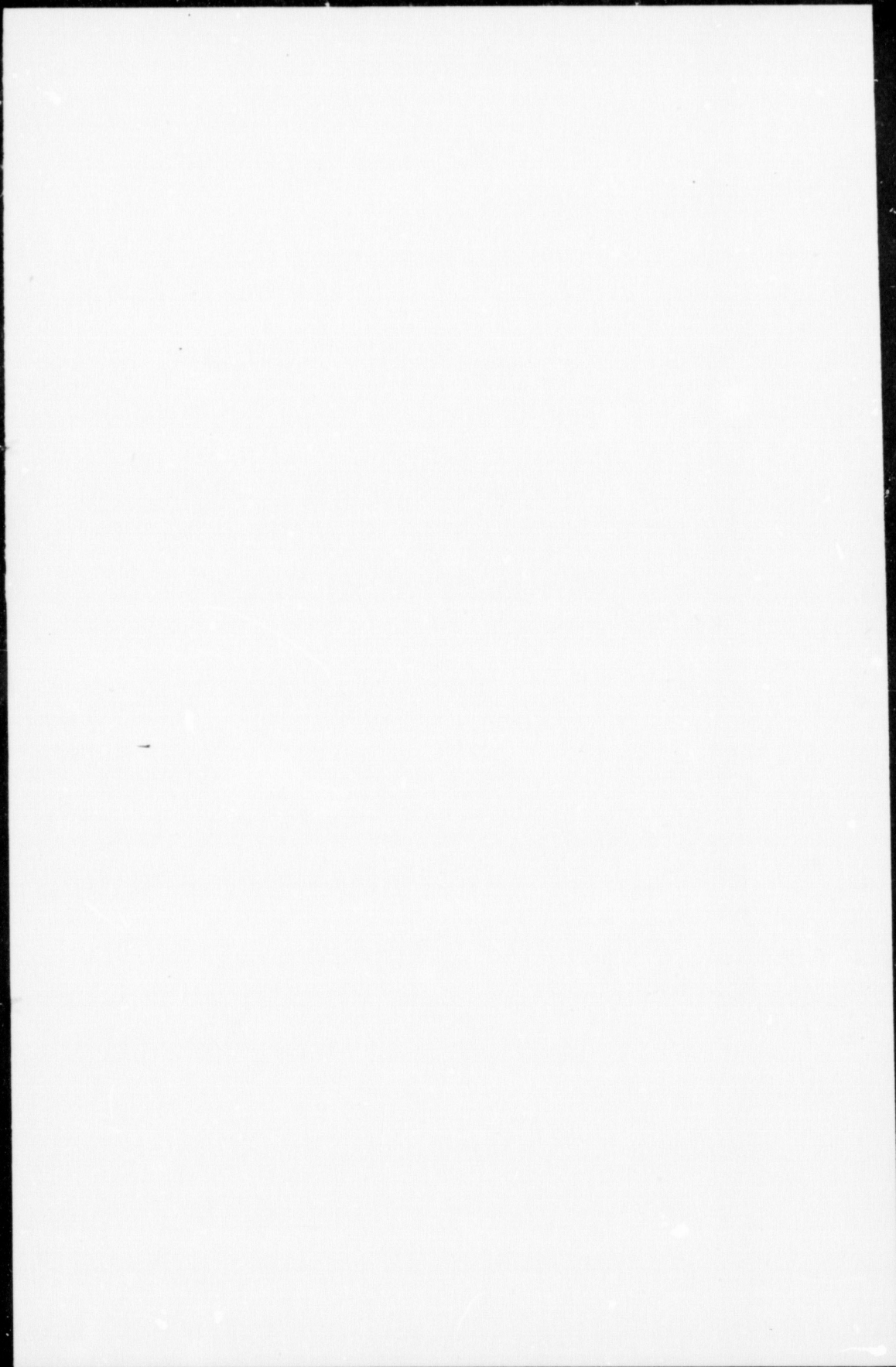
There is no basis to sustain a summary judgment for the plaintiff in the face of the lower court's own determination that a hearing is necessary to resolve a factual dispute as to the amount of attorneys' fees incurred by the defendant in connection with the transaction in question.

There was no sale within the meaning of the Agreement, only a like-kind exchange.

Even assuming a sale, the intent of the parties in reaching this Agreement was to provide for redemption of plaintiff's 25% interest in the defendant based on the book value of the defendant's assets, adjusted in some cases to reflect anticipated increase in book value in the event of a sale. This intent is thwarted under the District Court's approach since defendant is treated as if it received \$830,000 cash for the South Street Property when in fact it received like-kind property on Magee Avenue of unknown value subject to deferred capital gains taxes. Provision must be made for those deferred taxes in determining "net selling price", if any.

For all the foregoing reasons, the judgment of the District Court should be reversed, with costs, and the cause remanded or dismissed as appropriate.

Respectfully submitted,
Samuel V. Schoonmaker, III
Paul E. Knag



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